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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 127

FEDERAL POWER COMMISSION, *Petitioner*

v.

UNITED GAS PIPE LINE CO., ET AL.

No. 128

MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioner*

v.

UNITED GAS PIPE LINE CO., ET AL.

On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR MEMPHIS LIGHT, GAS AND WATER DIVISION

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BRIEF FOR MEMPHIS LIGHT, GAS AND WATER DIVISION

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit is reported at 357 F. 2d 230 (II R. 70-72). The opinions and orders of the Federal Power Commission are reported at 31 FPC 1180 (II R. 32-55), the relevant portions of which are pages 1190 and 1191 (II R. 40-42), and 32 FPC 687, 879, and 1163.

JURISDICTION

The judgment of the Court of Appeals was entered on February 10, 1966 and issued as its Mandate on March 7, 1966 (II R. 73-74). The petitions for writs of certiorari in Nos. 127 and 128 were filed on May 11, 1966. They were granted on June 13, 1966 (II R. 75-76). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing the rates charged by a natural gas company, the Federal Power Commission must allow as a cost of service the amount of Federal income taxes the natural gas company would have paid if it had filed a separate tax return, when in fact it joined with affiliated corporations, whose operations are not entirely subject to the Commission's regulatory jurisdiction, in filing a consolidated tax return which resulted in a net tax saving for the participants.

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3, et seq., as amended, 26 U.S.C. 1-8023, are printed in an Appendix to the Brief for the Federal Power Commission in No. 127.

STATEMENT

1. The Interest of Petitioner, Memphis Light, Gas and Water Division

Petitioner Memphis Light, Gas and Water Division ("Memphis") is a division and wholly-owned agency of the City of Memphis, Tennessee. In addition to owning and operating water and electric distribution systems, Memphis owns and operates a gas distribution system for the distribution and sale of natural gas throughout the City of Memphis and in Shelby County, Tennessee, to residential, commercial, and industrial consumers.

To meet the natural gas needs of these consumers, Memphis purchases all of its natural gas requirements from Texas Gas Transmission Corporation ("Texas Gas"), an interstate natural gas pipeline company, which, in turn, obtains substantial volumes of natural gas from United Gas Pipe Line Company ("United").

The most important and largest item affecting Texas Gas' rates to Memphis is the cost of the gas purchased by Texas Gas from United and other suppliers. In turn, the cost of the gas purchased by Memphis from Texas Gas is also the largest and most important element affecting the level of rates Memphis must charge the ultimate consumers. Consequently, United's rates to Texas Gas are of vital concern to Memphis.

In rate proceedings before the Federal Power Commission ("Commission"), on United's proposals to increase its rates to Texas Gas and others, including the one giving rise to the present controversy, Memphis has been granted full intervention as a party and has actively participated in the proceedings. In the court below, Memphis was also granted intervention. It filed

a brief and participated in the oral argument in support of the Commission's orders.

The decision of the court below will require the Commission to allow, and the ultimate consumers of natural gas to pay, in rates an amount for federal income taxes in excess of United's share of the groups' federal income tax liability, and thus, in effect, require them to subsidize non-utility operations. For the Commission, under that decision, must compute United's income tax allowance on the fiction that it files a separate tax return, although, in fact, it files no separate return but through participation in a consolidated tax return experiences a smaller tax due to recurring tax losses of an affiliated gas producer whose operations are an integral part of the public utility system and which is subject to regulation by the Commission as a "natural gas company".

The decision of the court below, if affirmed, will increase the cost of gas to over 100,000 gas consumers served by Memphis. The decision will also adversely affect the cost of gas to millions of gas consumers throughout the country who purchase gas sold by the 39 natural gas pipeline companies that participate in consolidated tax returns (FPC Petition for Certiorari, p. 15).

The effect of the Fifth Circuit's decision is not only far-reaching in terms of the number of consumers that will be adversely affected thereby, but it is also far-reaching in the effect on "the primary aim" of the Natural Gas Act "to protect consumers against exploitation at the hands of natural gas companies", *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 610. The decision can only

impede the Commission's administration of the Act to attain its objective.

Memphis readily agrees that consumers of natural gas should pay every legitimate and reasonable cost actually incurred by the natural gas pipeline companies and their gas producing affiliates in rendering natural gas service, including income taxes, but Memphis submits that it is neither appropriate, necessary, nor lawful to require consumers to pay amounts which exceed the actual costs for federal income taxes or any other component of cost of service, and thereby allow the utility to earn excessive returns at the expense of the consumers. *El Paso Natural Gas Company* v. *Federal Power Commission* (CA 5, 1960), 281 F. 2d 567, 571, *certiorari* denied, 366 U.S. 912. Tax savings will have been translated into additional profits for the benefit of United's parent.

2. Background of the Controversy

United is one of the largest interstate natural gas pipeline companies in the country. It sells natural gas for resale to other pipeline companies and distributors. As a "natural gas company" within the meaning of the Natural Gas Act, United's rates and charges for the interstate transportation and sale of natural gas for resale are regulated by the Commission (I R. 42).

United's parent is United Gas Corporation ("Corporation") and the affiliated companies are Union Producing Company ("Union") and United Overseas Production Corporation ("United Overseas").[1]

[1] United Overseas is engaged in foreign oil exploration (I R. 41). United Overseas participated in the consolidated tax return for the first time in 1961 when it had a net tax loss of $24,434 (I R. 41, 42, 87). Its role subsequent to 1961 is not revealed by the record (I R. 40, 41).

United, Union, and United Overseas are wholly-owned subsidiaries of Corporation (I R. 24, 37, 40).[2]

Corporation is engaged in the distribution of natural gas at retail in Texas, Louisiana, and Mississippi, and its rates therefor are subject to regulation by State or local regulatory authorities (I R. 40, 42). Corporation purchases practically all of the gas it distributes from United. *Standard & Poor's Corporation Records, Standard Corporation Descriptions,* July 30, 1965, Vol. 26, No. 21, Section 2, p. 3416.

Union is engaged in the exploration, development and operation of natural gas and oil properties (I R. 41). Union is United's "producing arm" or department, and about 80% of the gas produced by Union is sold to United. *Union Producing Company,* 31 FPC 41, 43-44 (1964); *Mississippi River Fuel Corporation* v. *Federal Power Commission,* 252 F. 2d 619, 622-623 (CADC, 1957); *Willmut Gas and Oil Company* v. *Federal Power Commission,* 299 F. 2d 111 (CADC, 1962). Union's rates for the sale of natural gas in interstate commerce, which includes its sales to United, are regulated by the Commission (I R. 42). *Union Producing Company, supra.* Its sales of oil and related gas liquid products are not regulated (I R. 42).

United dominates the system. Its gross operating revenues in 1961 were $298 million as compared to $50 million for Corporation and $52 million for Union. *Moody's Public Utilities Manual* (1962), p. 1368.[3]

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[2] Corporation owns all of the capital stock and all of the outstanding long-term indebtedness of each of the subsidiary companies (I R. 40).

[3] In 1965, United's gross operating revenues were $326 million; Corporation's were $57 million; and Union's were $53 million. *Moody's Public Utilities Manual* (1965) p. 1706.

During the period 1957 through 1961, of the system's taxable income, Corporation aggregated $9,024,170, or 7.89 per cent, and United aggregated $105,290,983, or 92.11 per cent (II R. 53).

By filing a consolidated Federal income tax return, as permitted by Section 1501 of the Internal Revenue Code (26 U.S.C. § 1501), the members of the System (Corporation and affiliates) realized tax savings which they could not have achieved by filing separate returns.[4] For the 1957 to 1961 period, the System's aggregate consolidated Federal income tax liability was $57,199,881 (II R. 53). Had United, Corporation and Union filed separate tax returns their combined tax liability for the same period would have been $59,291,919.[5]

The tax saving resulted from the fact that despite the substantial profits earned by Corporation, United and Union[6] during this period, special statutory tax deductions available to Union as an oil and gas producer (for depletion and intangible drilling costs) enabled Union for tax purposes to show a net tax loss,

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[4] A number of so-called name-saving companies are also included in the consolidated return (I R. 24, 40). These companies have no income or expenses and are, therefore, not germane to the question presented to this Court (I R. 40).

[5] The tax saving was actually substantially greater. This figure ignores about $5,000,000 of taxes Corporation, on a separate tax return basis, would have paid on dividends received from United and Union. Since these dividends do not enter into a consolidated tax return (the participants are treated as a single entity), the comparison has been made without regard to this additional tax saving.

[6] Union had substantial profits in the period 1957 to 1961. Its net income ranged from about $11,500,000 to about $18,000,000 (II R. 4).

for the period, of $3,869,626, which, under a consolidated tax return could be, and was, used to reduce the taxable net income of the System (I R. 38, 70; II R. 7-21).

The consolidated tax liability (and consequently the tax savings) is allocated by the System (I R. 34) in accordance with a method authorized by Section 1552 (a)(1) of the Internal Revenue Code (26 U.S.C. § 1552, § 1552(a)(1)) which provides that—

> "The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income."[7]

Since Corporation and United were the only members of the group with taxable incomes, they shared in the consolidated tax liability (and the resultant tax saving) in proportion to their relative net taxable incomes (I R. 34). United, therefore, through its participation in a consolidated tax return incurs a tax which is substantially less than the tax it would incur on a separate tax return basis.

Cognizant of these facts, the Commission rejected United's claim for a Federal income tax allowance in cost of service based on the fiction that United files a

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[7] Allocation of the joint tax cost is required by the Code for tax purposes to determine whether dividends were paid out of earnings or capital. The Securities and Exchange Commission also requires allocation of the joint tax cost for the purpose of proper financial reporting to investors and the public, and authorizes use of the methods prescribed in Section 1552(a). *Regulations under the Public Utility Holding Company Act*, Section 250.45(b)(6).

separate tax return (II R. 41-42). It adhered (II R. 41) to its established administrative practice, at that time most recently reflected in its decision in *Cities Service Gas Company*, 30 FPC 158 (1963), where it stated that when a consolidated tax return is filed "the task is then to determine the proportion of the consolidated tax which is reasonably attributable to" the company before the Commission (30 FPC, at 162). The Commission there held that "the proper method to be applied in computing the Federal income taxes to be included in cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is" as follows (30 FPC at 164):

> "(1) separate the companies into regulated and unregulated groups,
>
> (2) determine the net aggregate taxable income of each group, and
>
> (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis."

The Commission chose the 5-year period of 1957 to 1961, inclusive, as a representative test period upon which to determine United's Federal income tax allowance for cost of service purposes, and applied the allocation method adopted in the *Cities Service* case,

supra (II R. 41).[8] In the present case, since all of the participants were regulated and Union had no net taxable income against which to offset the net tax losses, it was only necessary to allocate the actual consolidated tax paid in the period of $57,199,881 between United and Corporation in proportion to their taxable incomes for the 5-year period of $105,290,983 and $9,024,170, respectively (II R. 53).[9] The average annual consolidated tax for the 5-year period was $11,439,976. Since United's taxable income was 92.11 per cent of their total taxable income, United's share of the average annual consolidated tax for the 5-year period was $10,537,362. This was an effective tax rate of 50.04 per cent when related to United's separately computed average annual taxable income for the 5-year period of $21,058,197 (II R. 53).[10]

Using this average effective tax rate of 50.04 per cent,[11] and the test year taxable income of $19,868,464, the Commission included $9,942,179 in United's cost of service for Federal income taxes (II R. 52) instead

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[8] The Commission used a 5-year period for test period purposes to determine the appropriate tax allowance since a single year might not be representative of the company's experience.

[9] Although United Overseas is unregulated, it was disregarded because the record showed its participation only in 1961 with a tax loss of $24,354 which averaged about $5,000 for the 5-year test period and represented only .00023 percent of the average taxable income. In the circumstance, United Overseas could have no significant effect on the apportionment.

[10] Under the allocation method followed by the System, the tax actually allocated to United during the period represented an effective tax rate of 48.8 per cent (Ex. No. 36 (Rev.), T. 6524).

[11] The use of an effective tax rate to reflect tax savings realized through filing a consolidated tax return has been common practice in Commission cases for many years. *infra*, pp. 15-16.

of $10,331,601 (computed at 52 per cent) on the basis of a separate tax return.

On review, the court below simply adopted as its own the reasoning of the Tenth Circuit in *Cities Service Gas Company* v. *Federal Power Commission*, 337 F. 2d 97, in which the Tenth Circuit set aside the Commission's order in the *Cities Service* case, *supra*, 30 FPC 158. On the authority of the Tenth Circuit's decision, the court below held that United's Federal income tax allowance should have been computed on a separate return basis at the 52 per cent tax rate (II R. 71-72; 357 F. 2d 230, 231).

The Tenth Circuit in *Cities Service* stated (337 F. 2d at 98) that "reduction in the total tax liability resulted from offsetting the losses incurred by certain *non-regulated* affiliates against the taxable income of all other affiliates", and that, therefore—

> "The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of *nonregulated* and *unrelated* affiliates to calculate the tax allowance includible in the cost of service of a regulated company." (Italics supplied)

The Tenth Circuit held that the Commission had assigned the losses of the *unregulated* and *unrelated* business to the regulated business in violation of the Congressional requirement of a separation of the profits and losses between regulated and non-regulated business (337 F. 2d, at 101). In this case, the tax losses were incurred by a *regulated* and *related* affiliate,[12] but the court below did "not think there

[12] See page 6, *supra*.

are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision." (II R. 72; 357 F. 2d, at 231).

SUMMARY OF ARGUMENT

I

Assuming, *arguendo*, as the court below held, that only tax losses of regulated and related companies, participating in the filing of a consolidated tax return, may be considered in determining United's share of the consolidated income tax liability of the group, the Commission properly took into account Union's tax losses.

Union is a regulated and related company. Union, like United, is a wholly-owned subsidiary of Corporation. Union is also the production department of United, and as a 100 per cent affiliate "stands in the same position as does the integrated producing 'arm' of a pipe-line company". *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957).

Union sales of natural gas in interstate commerce —80 per cent to United—are regulated by the Commission. *Union Producing Company*, 31 FPC 41 (1964). Its oil operations are unregulated, but almost all of its oil production comes from wells which also produce natural gas.

Additionally, Union's cost of service, on which its rates to United are based, includes an allocated portion of Union's exploration and development costs. The allocation is made on the basis of Union's total exploration effort without regard to the hydrocarbon that may be discovered. These costs are borne by the consumers.

Finally, even if there are unrelated and unregulated activities of Union, no separation of Union's tax deductions between unrelated and unregulated and regulated and related operations was necessary. All that was required was a fair allocation of the consolidated income tax among the participants of the group. *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581, 588, 590-591 (1945).

II

In addition to Union's status as the production arm of United and a regulated natural gas company, other factors sustain the consumers' participation in the tax savings flowing from the consolidated tax return.

Union's and United's capital requirements are provided by Corporation, their parent, through the issuance of Corporation's securities to the public. United's cost of capital is, therefore, the cost of attracting capital to the System. The higher degree of risk of Union's production operations results in a higher System cost of capital which is reflected in United's rate of return and is borne by the consumers. Since the consumers bear a higher cost of capital attributable to Union's greater risks, the consumers are entitled to share in the tax savings realized by the System through offset of Union's tax losses against the taxable income of United and Corporation.

Additionally, through United's taxable income, assured by the consumers, the tax losses of Union are translated into assured tax benefits at 100 cents on the dollar. Without the assured taxable income of United, the tax losses are of only speculative value. Whether Union, in the carry forward and carry back period

prescribed by the Internal Revenue Code, would have taxable income to turn the tax losses into tax benefits, in whole or in part, is speculative.

III

The court below erred in holding that United, despite its participation in a consolidated tax return, actually incurred a federal income tax liability equal to 52 per cent of its taxable income and was, therefore, entitled to such an allowance in cost of service for federal income taxes.

While each company participating in a consolidated tax return, which has taxable income, viewed separately, *contributes* 52 per cent of that income to the tax liability of the System, there is no *separate computation or assessment of tax* and no *separate tax liability* for each participant in a consolidated tax return.

There is a single tax liability computed by (1) adding up the taxable incomes of each company, (2) reducing this sum by the tax losses of other companies in the group, and (3) multiplying the net taxable income of the group by the statutory tax rate. Had the court below computed a tax liability on a separate return basis for each participant, instead of for United alone, the court would have found that the summation of the separate tax liabilities would have exceeded the consolidated tax liability of the group, thus demonstrating that United, contrary to the court's holding, did not incur a tax liability equal to 52 per cent of its taxable income.

IV

The Commission allocated the consolidated tax liability between United and Corporation, the only

participants of the group with taxable income, on the basis of their respective average taxable incomes in the test period. This was eminently fair since tax liability is a function of taxable income and the rate, and Union had no taxable income. The Commission was not required to segregate properties or corporations. *Colorado Interstate Gas Company* v. *Federal Power Commission, supra.*

ARGUMENT

The Commission adhered to its long-established, administrative practice of including in cost of service an allowance only for taxes actually incurred. Where the company has participated in a consolidated tax return, the Commission has consistently refused to include a hypothetical tax allowance in cost of service based on a separate tax return. The Commission has included in cost of service only a tax allowance at the effective tax rate resulting from participation in the consolidated tax return. *Penn-York Natural Gas Company,* 5 FPC 33, 39 (1946); *Hope Natural Gas Company,* 10 FPC 583, 612, affirmed, 10 FPC 625 (1951); *Atlantic Seaboard Corporation,* 11 FPC 486, 515, affirmed, 11 FPC 43 (1952); *United Fuel Gas Company,* 12 FPC 251 (1953); *Hope Natural Gas Company,* 12 FPC 342, 347 (1953); *Home Gas Company,* 13 FPC 241 (1954); *Michigan Wisconsin Pipe Line Co.,* 13 FPC 326, 356, 373 (1954); *United Fuel Gas Company,* 23 FPC 127, 134 (1960). In *United Fuel Gas Company, supra,* 12 FPC at 265, the Commission said:

> "We have consistently held that consumers should be charged for only the actual liability for Federal income taxes. . . . If, by filing a con-

solidated return, a reduction of this cost is effected, such reduction should be reflected in the cost charged to consumers."

To arrive at United's fair share of the tax saving—and thereby to determine United's tax allowance for rate regulatory purposes—the Commission apportioned the consolidated tax liability among the participants in the consolidated return on the basis of their respective taxable incomes. United and Corporation had taxable incomes; Union had a net tax loss. Therefore, the consolidated tax was apportioned only between United and Corporation. On the basis of their respective taxable incomes, 92.11 per cent of the consolidated tax liability was allocated to United and 7.89 per cent to Corporation. The effective tax rate was 50.04 per cent.[18] The Commission applied this effective tax rate to compute United's tax allowance for cost of service purposes.

The court below reversed the Commission, adopting as its own the reasoning of the Tenth Circuit in the

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[18] The Commission has the duty, responsibility and right to determine what elements should be included in cost of service and the reasonable amount to be included for each element. The System's allocation method is not binding on the Commission in an affiliated situation. *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957); *Cities Service Gas Company* v. *Federal Power Commission*, 155 F. 2d 694 (CA 10, 1946), *certiorari* denied, 329 U.S. 773 (1946). Among the financial abuses uncovered by the Federal Trade Commission investigation which Congress intended to eliminate by enactment, in 1935, of the Public Utility Act of 1935 and Parts II and III of the Federal Power Act were the parent company's practices of assessing against the operating subsidiary a tax liability which deprived it of any benefit of the tax saving resulting from participation in the consolidated tax return. The tax saving thereby became additional profit to the parent. Senate Doc. 92, Part 72A, 70th Congress, 1st Session, pp. 477-482.

Cities Service case, *supra*. In *Cities Service*, the Tenth Circuit stated that the tax savings resulted from tax losses of "unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas" and held that the Commission could not legally consider tax losses of "non-regulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company" (337 F. 2d at pp. 98, 99). Additionally, the Tenth Circuit held that the natural gas company in that case had, in fact, experienced a 52 per cent tax liability notwithstanding its participation in the consolidated return (337 F. 2d at pp. 100-101). On the facts of this case, and as matter of principle, the court below erred.

I.

ASSUMING, ARGUENDO, ONLY TAX LOSSES OF REGULATED AND RELATED COMPANIES MAY BE CONSIDERED BY THE COMMISSION, UNION'S TAX LOSSES WERE PROPERLY CONSIDERED BY THE COMMISSION IN DETERMINING UNITED'S FEDERAL INCOME TAX ALLOWANCE.

Union is engaged in the exploration, development and operation of natural gas and oil properties, and has been judicially declared to be United's "producing arm" or production department. Eighty per cent of the gas produced by Union is sold to United. Union's sales of natural gas to United and rates therefor, as are all of Union's sales in interstate commerce, are regulated by the Commission under the Natural Gas Act. I. R. 41, 42; *Union Producing Company*, 31 FPC 41, 43-44 (1964); *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622-623 (CADC, 1957); *Willmut Gas and Oil Company* v.

Federal Power Commission, 299 F. 2d 111 (CADC, 1962).

Union's oil operations are unregulated, but almost all of Union's oil production comes from wells which also produce natural gas. Only 9.6 per cent of its net investment is applicable to 100 per cent oil fields. *Union Producing Company*, 31 FPC 41, 79 (1964). Union's cost of service, on which its rates to United are based, includes an allocated portion of Union's exploration and development costs which is made on the basis of Union's total explorations effort without regard to the hydrocarbon that may be discovered. Consequently, a *pro rata* share of the burden of Union's total exploration activities, whether related to regulated gas activities or unregulated, albeit related, oil activities, is underwritten and borne by the consumers.

On the basis of these facts, Union's tax losses were certainly those of a regulated and related affiliate and, by the test enumerated by the Tenth Circuit, and adopted by the court below, were properly taken into account by the Commission. No separation of Union's tax deductions between regulated and unregulated business, or between related and unrelated activities, was necessary, any more than a separation was necessary of the regulated and unregulated business of United, assuming part of the tax deductions were in fact the result only of unregulated oil operations, and assuming further that oil operations that are largely and intimately associated with the production of gas can be said to be unrelated to the regulated gas operations. A fair allocation of the consolidated income tax among the participants is all that is required. *Colorado*

Interstate Gas Company v. *Federal Power Commission*, 324 U.S. 581, 588, 590-591 (1945).[14]

Indeed, if Union's operations were part of the United corporate entity, rather than in a separate corporate entity, no one for one moment would think of suggesting that the tax deductions associated with the production operations must be disregarded in computing United's federal income tax allowance. *El Paso Natural Gas Company* v. *Federal Power Commission*, 281 F. 2d 567, 573 (CA 5, 1960), *certiorari* denied, 366 U.S. 912. In that case, El Paso Natural Gas Company was engaged in the production, transportation and sale of natural gas. It contended that its federal income tax allowance for rate purposes should be computed without regard to the savings in taxes produced by the tax deductions for statutory depletion and

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[14] See also *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 324 U.S. 635, 642, 646, 647, where this Court approved a profit-sharing formula in lieu of an allocation. And compare the cases where the courts have approved the Commission's use of revenues from extraction operations, which served to make the gas more marketable but reduced its heating value, to reduce the pipeline company's cost of service, without requiring the Commission to make an allocation between extraction operations related and unrelated to the marketing of the gas. *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 305 F. 2d 763 (CADC, 1962, *certiorari* denied, 372 U.S. 916); *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 348 F. 2d 340 (CADC, 1965), affirming 32 FPC 636 (1964); *Hope Natural Gas Company* v. *Federal Power Commission*, 134 F. 2d 287, 307-308 (CA 4, 1943), reversed on other grounds, 320 U.S. 591 (1944); *Cities Service Gas Company* v. *Federal Power Commission*, 155 F. 2d 694, 703 (CA 10, 1946), *certiorari* denied, 329 U.S. 773 (1946). In the present case the Commission has made an allocation.

intangible well-drilling costs. The Fifth Circuit disagreed, saying (at page 573):

> "We think, in short, there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.
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> "We conclude that the two true tax savings are to be treated alike. Other than the depreciation item, whatever federal income taxes were actually paid for the test year should be treated as part of the cost of service regardless of whether these taxes were less than would have been paid but for the depletion allowance and the deduction for intangible drilling expense. No theoretical amount not actually paid can be so included."

The court's reasoning is no less applicable to the present case. "A 100 per cent affiliate stands in the same position as does the integrated producing 'arm' of a pipe-line company", *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957). The D.C. Court of Appeals in stating this general rule was there applying it specifically to Union.

Consequently, by the tests established by the court below, it erred in holding that the Commission's order transgressed its statutory authority.

II.

OTHER CONSIDERATIONS DISCLOSE PROPRIETY OF OFFSETTING UNITED'S TAXABLE INCOME WITH A FAIR SHARE OF UNION'S TAX LOSSES FOR RATE MAKING PURPOSES.

Regardless of Union's status as the production arm of United and as a regulated natural gas producer, there are factors present which sustain the consumers' participation in the tax savings. United and Union have no securities outstanding in the hands of the public. All of their securities are held by their parent, Corporation. The capital requirements of United and Union are supplied by Corporation through the issuance of Corporation's securities which are widely held by the investing public in the United States. United's cost of capital, which determines its fair rate of return, is, therefore, the cost of attracting capital to the System, and the Commission has provided rates of return for United and Union on this basis. *United Gas Pipe Line Company,* 25 FPC 35, 108-109, 110, 115, affirmed 25 FPC 26, 32 (1961); *Union Producing Company,* 31 FPC 41.

Exploration, development, and production operations of Union involve higher degrees of risk and uncertainty than do the pipeline operations of United. This higher degree of risk is reflected in the cost of capital incurred by Corporation in raising capital and is, in turn, reflected in the rate of return awarded United in light of that cost of capital. Thus, United's consumers bear increased costs of capital directly traceable to Union's riskier operations. Since United's consumers bear a higher cost of capital due to Union's greater risks, it is appropriate, and fairness and equity require, that the consumers share in the tax savings realized by the System by reason of the offset

of Union's tax losses against the taxable income of United and Corporation.[15]

Additionally, United's consumers are entitled to a fair share of the tax savings available to the System through offset of Union's tax losses against United's and Corporation's taxable income because there is no assured realization of the *full* benefit of the tax losses without the taxable income of United provided by the consumers. In fact, without the assured profits of United, there is no assurance that *any* tax benefit could be realized from Union's tax losses.

Unless used in a consolidated tax return as an offset to taxable income, Union's tax losses could only be used by Union as an offset to taxable income of its own in filing a separate tax return. If Union filed a separate tax return, it would have the right to offset its tax losses against taxable income of three prior years or against the taxable income of five prospective years (26 U.S.C. § 172). There must be taxable income to make this right valuable, and the taxable income must be of sufficient level to absorb the tax losses if the tax losses are to have a value equal to 100 cents on the dollar. It is entirely speculative whether Union would have taxable income within the prescribed time periods to enable it to turn tax losses into tax benefits and the extent to which this might be possible. On the basis of past experience during 1957 to 1961, as shown by the record (Ex. No. 36 (Rev.); T. 6524),[16] Union had

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[15] Pipeline companies have branched into unregulated, and sometimes unrelated, ventures with the knowledge that the tax losses of these ventures can be turned into tax benefits by reason of the ever-present, assured taxable income of the regulated business.

[16] "T." followed by page references refers to the portion of the record which has not been printed. The page reference is to the numbering employed by the Commission in certifying the record to the court below.

taxable income only in 1958 and in an amount insufficient to absorb more than 50 per cent of the tax losses for the 5-year period.

By filing a consolidated tax return, however, because of the assured taxable profits provided by United's consumers, the tax losses are translated into assured tax benefits at 100 cents on the dollar.

This contribution which the consumers make is of no small moment, and of itself is sufficient to sustain the consumers' participation in the tax saving resulting from the consolidated tax return.

III.

UNITED INCURRED NO TAX LIABILITY EQUAL TO 52 PER CENT OF ITS TAXABLE INCOME.

A basic premise of the Tenth Circuit, which the Fifth Circuit adopted, was that Cities Service Gas Company actually incurred a tax liability of 52 per cent of its separate taxable income, notwithstanding its participation in the consolidated tax return (337 F. 2d 100). Therefore, it reasoned that the Commission should have included in cost of service a federal income tax allowance based on 52 per cent of Cities Service Gas Company's taxable income.

The Tenth Circuit arrived at its conclusion by a mathematical exercise (337 F. 2d, at p. 100, note 4). The Tenth Circuit computed the regulated company's separate tax liability at 52 per cent of its taxable income. This amount was subtracted by the court from the consolidated tax liability, and the resulting balance was described as the "Consolidated tax (excluding Gas Company)." The Tenth Circuit then added back the separate tax liability which produced the original consolidated tax liability including the

Cities Service Gas Company.[17] From this the Tenth Circuit concluded (337 F. 2d 100, 101):

> ". . . The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company."
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> ". . . as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 per cent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies."

A similar mathematical exercise was performed by United in the court below to show that United, notwithstanding its participation in a consolidated tax return which produces a tax saving, incurred a tax liability equivalent to 52 per cent of its separate taxable income. The Fifth Circuit apparently agreed.

The mathematical exercise is utterly meaningless as is the conclusion drawn therefrom that Cities Service Gas Company, and in this case United, incurred an actual tax liability of 52 per cent.

Of course, viewed separately, each company having taxable income *contributes* 52 per cent of that income to the tax liability of the System, but if this implies a *separate assessment of tax* or *separate tax liability* equal to 52 per cent of the separate taxable income, it

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[17] In those years where only Cities Service Gas Company had taxable income the Tenth Circuit showed the consolidated tax, excluding that company, as a minus tax (i.e., a negative tax) which was used by the court to offset the taxable income it had computed for the Gas Company in order to get back to the starting point.

is in error. United is not assessed separately from the group and no group exists except the one which includes United. In order to file a consolidated return, every subsidiary in which the parent company owns 80 per cent or more of the stock must join in the return, and there is a single tax liability computed by adding up the taxable incomes of each company and offsetting against such taxable incomes the tax losses of other companies in the group. The tax liability is determined by applying the statutory tax rate to the resulting total net taxable income of the group. The consolidated tax return unites the participants for purposes of the tax computation and the equitable apportionment of the tax among them. No separate tax liability of each participant is computed. To be sure, each participant is severally liable for the consolidated tax liability, but there is never any application of the statutory tax rate to any participant's separate taxable income.

The fallacy of the Tenth Circuit's (and the Fifth Circuit's) mathematical exercise, which assumes the same tax liability for the group on a separate and consolidated basis, is easily demonstrated. Assume that four corporations join in a consolidated return and have separate taxable income or tax loss as follows:

Corporation	Taxable Liability (Tax Loss)
A	$20,000
B	10,000
C	5,000
D	(5,000)
Total net taxable Income	$30,000

At a 52 per cent corporate tax rate, the consolidated tax liability (52 per cent × $30,000) is $15,600.

If, however, the Tenth and Fifth Circuits' theory of a separate actual liability of 52 per cent for each participant in a consolidated tax return was valid, the income tax liability of Corporations A, B, C, and D would separately, and in total, be as follows:

A	$10,400 (52% of $20,000)
B	5,200 (52% of $10,000)
C	2,600 (52% of $5,000)
D	—0— (52% of zero taxable income)
Total Tax Liability	$18,200 (52% of $35,000)

Since the $18,200 exceeds the consolidated tax liability of $15,600, it is apparent that each participant with taxable income in the consolidated tax return does not *incur* a tax liability equal to 52 per cent of its taxable income; the theory of the Tenth and Fifth Circuit is fundamentally fallacious. The Tenth Circuit and the court below went astray because they did not compute a separate tax liability for each participant, add up those computations, and compare the summation to the consolidated tax liability.

The theory of the Fifth and Tenth Circuits could only produce a consolidated tax liability of $15,600 by assigning a "negative tax" of $2,600 to Corporation D. This, however, would neither be accurate nor realistic. The Bureau of Internal Revenue has ruled that no such "negative tax" allocation may be made. It held that the tax "should be apportioned among the members of the group in accordance with the ratio of that portion of the consolidated normal-tax net income attributable to each member of the affiliated group to the consolidated normal-tax net income, *leaving out of consideration any member of the group having no net income*" (italics supplied). Income Tax Ruling No.

4085, *Bureau of Internal Revenue Cumulative Bulletin 1952,* Vol. 1, p. 68.

Corporation D's tax loss position (here Union) cannot benefit anyone except its affiliates A, B and C (here United and Corporation). This is accomplished through a consolidated tax return as a result of which United's tax liability is less than its tax liability on a separate tax return basis.

Therefore, to the extent that the Fifth Circuit reversed the Commission's order on the premise that United incurred a tax liability equal to 52 per cent of its separate taxable income, which should have been allowed, the Fifth Circuit was in error.

IV.

THE COMMISSION'S ALLOCATION METHOD DID NOT EXCEED ITS STATUTORY AUTHORITY.

The Commission allocated the consolidated tax liability between United and Corporation on the basis of their respective taxable incomes. No allocation of the consolidated tax liability was made to Union since it had no taxable income.

This disposition of the consolidated tax liability was appropriate since tax liability is a function of taxable income and the rate. Since Union had no taxable income, no apportionment to it of the consolidated tax liability was appropriate.[18] On the other hand, since tax liability is a function of taxable income and the rate, the apportionment of the liability between United and Corporation on the basis of their respective taxable

[18] In fixing Union's rates to United, the Commission in a consistent manner took Union's federal income taxes at zero. *Union Producing Company,* 31 FPC 41, 49-50 (1964).

incomes was eminently fair. It was in accord with allocation methods authorized by the Internal Revenue Code for tax purposes by the consolidated group and by the Securities and Exchange Commission for its regulatory purposes. 26 U.S.C. § 1552; SEC Holding Company Act Regulations, Sec. 250.45(b)(6).

As shown above, the Commission did not thereby appropriate tax losses of unregulated and unrelated business for the benefit of regulated business since Union is a regulated and related business.

Moreover, this is not an appropriate test. The consolidated tax return is for the benefit of each participant. Indeed, the taxable incomes provide the assurance that the tax losses can be beneficially used to the full extent and to the full extent of their value. Whether or not the tax saving—benefit—of the consolidated tax return is the result of tax losses of unregulated and unrelated businesses, each participant having taxable income (here United and Corporation) is entitled to share in the benefit. The Commission's method in this case accomplished this in a fair and rational manner. To apportion a joint cost, neither segregation of properties or corporations is required. *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581, 588, 590-591 (1945).

CONCLUSION

WHEREFORE, for each and all of the reasons set forth in this brief the decision of the court below should be reversed and the Commission's orders affirmed.

Respectfully submitted,

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